

CHAPTER 23

Tax Planning for Interest After TRA 1984: Unstated Interest and Original Issue Discount

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§ 23.01 INTRODUCTION

Prior to the enactment of the Tax Reform Act of 1984 (TRA 1984),¹ purchases and sales of real estate were structured to take advantage of the inadequate way in which the tax law dealt with the time value of money and its primary indicator, interest. While the Code contained provisions dealing to some extent with unstated interest and the method in which that interest was deemed to be earned,² those provisions by and large proved inadequate to prevent certain abuses. Further, the benefits to be derived by purchasers from exploiting those abuses could be distributed to high income investors by means of syndicated limited partnerships.

In TRA 1984, Congress sought to accomplish two principal objects: first, to apply economic theory to determine the tax consequences of business transactions, and, second, to impose a uniform method of accounting for interest on both sides of a sales transaction. In order to understand how Congress accomplished those goals, one first should look at tax planning objectives prior to the legislative changes.

Tax planning in real estate transactions prior to TRA 1984 generally involved the use of seller financing to accomplish four principal objectives:

- (1) obtaining a basis in the purchased property greater than its value;
- (2) obtaining a deduction for the accrual of unpaid interest on the loan that financed the purchase;
- (3) accelerating or "front-loading" interest deductions so that interest would accrue on a noneconomic basis; and

¹ Pub L No 98-369, 98th Cong, 2d Sess (July 18, 1984).

² IRC § 483 (prior to amendment by TRA 1984) and IRC §§ 1232A and 1232B (both sections repealed by TRA 1984), respectively.

- (4) deferring interest income to the seller and changing the character of a portion of that interest from ordinary income to capital gain.

§ 23.02 STATUTORY FRAMEWORK PRIOR TO TRA 1984

Even prior to TRA 1984, the Code contained provisions designed to constrain taxpayers seeking to attain those four objectives. Some of those provisions worked inadequately, and some, because of their limited scope, did not work at all.

Unstated or understated interest on purchase money financing. IRC Section 483, prior to its amendment, dealt with seller financing or purchase money debts that failed to contain adequate provision for the payment of interest on deferred payments. In those situations, the section, in general, treated a portion of the principal of those payments as “unstated interest.” In general, IRC Section 483 imputed interest at the annual rate of 10 percent, compounded semiannually, if the deferred payment contract of sale did not provide for an annual stated interest rate of at least 9 percent simple interest (safe harbor “test rate”).³ Imputed interest was allocated proportionately among payments on the debt, rather than as the interest would be deemed to accrue economically.⁴ For example, if a deferred payment note provided for two equal payments, one due one year after the date of sale, and the other due ten years after the date of sale, and no provision was made for interest, interest would be imputed under IRC Section 483, and that imputed interest would be allocated equally between the payments. Economically, however, most of the interest should have been allocated to the later payment because a greater portion of that payment represents compensation to the seller for awaiting payment.

Further, the section dealt with sales only.⁵ It did not cover deferred payments for services, for the use of property or other nonsales situations. In substance, however, the section forced tax-

³ Reg § 1.483-1(d)(1)(ii)(C) and 1(c)(2)(ii)(C) (issued prior to amendment of IRC § 483 by TRA 1984).

⁴ Reg § 1.483-1(a)(1) (issued prior to amendment of IRC § 483 by TRA 1984).

⁵ IRC § 483(c)(1) (prior to amendment by TRA 1984).

payers to provide for interest in the contract at least in an amount computed at the 9-percent simple interest test rate.

Accrual of interest. IRC Section 1232A dealt with the manner in which certain interest was deemed to be earned. That interest was called original issue discount (OID). OID, in substance, is the difference between the stated amount the lender will receive when the debt is paid and the amount he actually loaned the debtor. That difference is really payment for the use of the money and therefore interest. Accordingly, the statute treats it as interest.

Technically, OID was defined as the excess of the face amount of the obligation (i.e., its "redemption price") over the "issue price" of the obligation.⁶ Prior to the enactment of the Tax Equity and Fiscal Relief Act of 1982 (TEFRA),^{6,1} OID income and deductions were deemed to accrue under the straight-line method in equal amounts each month.⁷ As a result of the enactment of TEFRA, however, the OID provisions were amended so that OID was deemed to accrue economically.⁸ Taxpayers reported the portion of OID representing economically accrued interest each year without regard to their method of accounting.

The OID provisions, however, both before or after TEFRA, did not encompass all debt transactions involving OID. For example, the provisions did not deal with bonds or other evidences of indebtedness issued in exchange for property (other than stock or securities traded on an established securities market) if such bonds or evidences of indebtedness were not part of a publicly traded issue,⁹ or with evidences of indebtedness issued by individuals.¹⁰ Furthermore, there was no provision in IRC Section 1232 that dealt with a bond or other evidence of indebtedness issued as compensation for services.¹¹

Allocation of interest among controlled taxpayers. IRC Section

⁶ IRC § 1232A (repealed by TRA 1984).

^{6,1} Pub L No 97-248, 97th Cong, 2d Sess (Sept 3, 1982).

⁷ IRC § 1232 (repealed by TRA 1984).

⁸ See IRC § 1232A(a) (repealed by TRA 1984).

⁹ IRC § 1232(b)(2) (repealed by TRA 1984).

¹⁰ IRC § 1232A(a)(2)(A) (repealed by TRA 1984).

¹¹ See IRC §§ 1232(a) (repealed by TRA 1984), 1232A(a)(1) (repealed by TRA 1984) and 1221(4).

482 also dealt with the interest element in transactions. That section provided for allocation of interest income and deductions among two or more commonly controlled organizations, trades or businesses to prevent evasion of taxes or to clearly reflect income. The section contained the requirement to charge arm's length interest, and the regulations thereunder provided safe harbor rules.¹²

Capitalization of interest expense. Finally, IRC Section 461(g), enacted under the Tax Reform Act of 1976,^{12.1} in general, disallows as a current interest deduction interest paid by a cash-method borrower that is properly allocable to another period.¹³ Interestingly, the section does not set forth a rule for determining how much of the interest paid is chargeable to the current period and how much to a future period. There are no regulations promulgated under IRC Section 461(g). The section, however, does provide a special rule for the immediate deduction of points paid in connection with a taxpayer's principal residence.¹⁴

§ 23.03 TAX PLANNING PRIOR TO TRA 1984

Notwithstanding the array of special provisions dealing with

¹² Reg § 1.482-2(a)(2).

^{12.1} Pub L No 94-455, 94th Cong, 2d Sess (Oct 4, 1976).

¹³ The section provides as follows:

“(g) Prepaid Interest.—

“(1) In general.—If the taxable income of the taxpayer is computed under the cash receipts and disbursements method of accounting, interest paid by the taxpayer which, under regulations prescribed by the Secretary, is properly allocable to any period.—

“(A) with respect to which the interest represents a charge for the use or forbearance of money, and

“(B) which is after the close of the taxable year in which paid,

“shall be charged to capital account and shall be treated as paid in the period to which so allocable.

“(2) Exception.—This subsection shall not apply to points paid in respect of any indebtedness incurred in connection with the purchase or improvement of, and secured by, the principal residence of the taxpayer to the extent that, under regulations prescribed by the Secretary, such payment of points is an established business practice in the area in which such indebtedness is incurred, and the amount of such payment does not exceed the amount generally charged in such area.”

¹⁴ IRC § 461(g)(2).

interest, many tax practitioners prior to TRA 1984 believed that the four tax planning objectives could be accomplished, even when complying with the existing statutory scheme. An example will demonstrate the manner in which those objectives were accomplished.

[1] Objective 1: Increasing Basis

When a taxpayer purchased property for cash, his basis in the property was the amount of cash paid. Thus, a taxpayer who purchased property worth \$1 million for \$1 million cash obtained a basis in that property of \$1 million whether he paid his own cash or borrowed the \$1 million purchase price from a bank and used the property as security for the loan. Likewise, the result was the same if the taxpayer instead borrowed the \$1 million from the seller by giving the seller a purchase money mortgage in the amount of \$1 million bearing interest at the market rate for comparable loans. It should be supposed, however, that the taxpayer arranged his purchase money mortgage to pay the same total amount (interest plus principal) but specified a high principal amount with a below market interest rate.

For example, the taxpayer purchased real property worth \$1 million with a long-term note worth \$1 million. The note did not bear interest at the market rate but instead contained the following terms:

- (1) It had a face amount of \$2,444,040.¹⁵
- (2) It bore interest at the annual rate of 9-percent simple (when the market rate of interest was 12 percent compounded semiannually).
- (3) It was payable in full, both interest and principal, in 15 years.

The purchaser who structured his purchase in that manner prior to TRA 1984 expected to increase his basis for depreciation purposes from \$1 million to \$2,444,040. Depreciation for the first full year under the straight-line method would be \$135,780 instead

¹⁵ That number was derived by computing the present value of the total amount of payments, including principal and interest, due at the maturity of the obligation, using a discount factor of 12 percent compounded semiannually.

of \$55,556, the depreciation the purchaser would have been allowed on property with a basis of \$1 million.

The trade-off for the purchaser's high basis was that all of the payments of the purchase price (the principal of the note) would be nondeductible principal rather than deductible interest. Any such trade-off was generally advantageous, however, as long as the increased depreciation deductions in the early years exceeded the amount of the "lost" interest.

As a result of the Economic Recovery Tax Act of 1981 (ERTA),^{15,1} depreciation of "recovery property" (tangible property used in a trade or business or held for the production of income),¹⁶ is now computed under the accelerated cost recovery system (ACRS) without regard to the actual economic useful life of the property. Thus, the period of depreciation for most types of property has been shortened, making it more likely that the term of the loan will be almost as long or longer than the ACRS useful life of the purchased property. This phenomenon is particularly true with regard to real property, which is generally depreciable under ACRS over 18 years,¹⁷ or in the case of low-income housing, which is depreciable over 15 years.¹⁸

In the example, if the purchaser used the cash method of accounting, he would not have been entitled to any deduction for interest until he paid it. Thus, a high face amount on the note permitted current depreciation deductions without any loss of current tax benefits. Even a taxpayer using the accrual method of accounting could have benefited from the plan, if his increased depreciation deductions more than offset his reduced interest deductions.

Thus, the tax benefits from depreciation would likely have outweighed the loss of tax benefits from interest deductions. Moreover, if the property were eligible for the investment tax credit, a higher basis would have resulted in an even greater advantage to the purchaser using "creative" seller financing. Providing a high purchase price by stating a high principal amount on the low

^{15,1} Pub L No 97-34, 97th Cong, 1st Sess (Aug 13, 1981).

¹⁶ IRC § 168(c).

¹⁷ IRC § 168(c)(2)(D).

¹⁸ IRC § 168(c)(2)(D)(ii), (b)(4).

interest promissory note magnified the amount of the investment tax credit. For example, if the property described in the example were five-year personal property eligible for the investment tax credit, that credit would have been \$244,040 instead of \$100,000,¹⁹ resulting in a substantial tax savings for the purchaser.

The technique that was involved in overstating cost and therefore basis of purchased property was the exploitation of the 9-percent simple interest safe harbor test rate of IRC Section 483. The section left unaffected a deferred payment purchase that provided for an interest rate of at least 9 percent per annum simple interest. The safe harbor rule permitted those abuses because it dealt inadequately with the problem on two accounts. First, during times of high inflation and therefore high market interest rates, 9 percent may be substantially below the prevailing interest rate. Thus, the purchase of property for a purchase money mortgage bearing 9-percent interest may result in a stated purchase price and face amount of the note substantially in excess of the fair market value of the property or note.

Second, even during times when 9 percent represented an approximation of the market rate of interest, the fact that the safe harbor was available for simple interest rather than compound interest created great potential for abuse. Under a provision for simple interest, the lender earns no additional interest on earned but unpaid interest. For that reason, simple interest is nonsensical from a commercial point of view. Where all current interest payments are made currently there is no difference between 9-percent simple and 9-percent compound interest. In situations in which current payments are not required, however, a 9-percent simple interest payable at the end of the loan results in an effective rate of interest of substantially less than 9-percent compound interest. For example, on a 15-year loan providing for 9-percent simple interest with all interest and principal payable in year 15, the effective rate of compound interest is approximately 5.78 percent.²⁰ Accordingly, the basis of the property and the resultant

¹⁹ The amount of investment tax credit is generally 10 percent of the cost of the property. IRC § 46(a) and (b).

²⁰ That number was derived by computing the interest rate, based on semiannual compounding, that would cause \$1 invested today to increase to \$2.35 ($\$1 + (9\% \times \$1 \times 15)$) after 15 years.

ACRS depreciation would be substantially in excess of those warranted by the fair market value of the property and purchaser's payment obligation.

While the example used here of a balloon payment of interest and principal may seem extreme, it does present a dramatic illustration of the problem with the old Section 483 test rate. More commonplace situations involving at least some current payment of interest differ from that case only in degree and not in kind.

The foregoing example has been simplified for purposes of exposition by focusing on the crucial element of the plan. The effect of the technique used was to magnify the basis of the \$1 million property to \$2,444,040 without forcing the purchaser to give the seller additional value. It would be more typical, however, for the purchaser to have made a downpayment, and perhaps additional payments during the first few years after closing. If the downpayment were \$1 million on a property with a fair market value of \$2 million, the favorable rate seller financing would have served to increase the purchaser's basis from \$2 million (the purchase price in a cash transaction) to \$3,444,040. Moreover, the seller's loan in the principal amount of \$2,444,040 would be secured, in effect, by the property, valued at \$2 million, minus the amount of any priority mortgage.

[2] Objective 2: Interest Deduction for Full Accrual

In general, under the accrual method of accounting, income is realized when the right to receive payment accrues (becomes fixed and determinable),²¹ and deductions are allowed when the obligation to make payment accrues.²² The time of payment or receipt for an accrual method taxpayer is irrelevant, except for certain advance payments required to be included in income.²³

The regulations under IRC Section 461 set forth a test for

²¹ Reg § 1.451-1(a).

²² Reg § 1.461-1(a)(2). See IRC § 461(h)(4).

²³ See, eg, *Schlude v Commr*, 372 US 128, 136-37 (1963); *American Auto Assn v US*, 367 US 687, 692 (1961), *reh denied* 368 US 870; *Automobile Club of Mich v Commr*, 353 US 180, 189 (1957), *reh denied* 353 US 989; *RCA Corp v US*, 664 F2d 881 (2d Cir 1981), *cert denied* 457 US 1133 (requiring immediate realization of income from services yet to be performed upon receipt of advance payments).

determining when an expense is deductible for an accrual-method taxpayer—the “all events test.” Under the “all events test,” in general, an expense of an accrual-method taxpayer is deductible in the taxable year in which:

- (1) “All the events have occurred which determine the fact of liability”; and
- (2) The amount of the liability “can be determined with reasonable accuracy.”²⁴

Even if the all events test is satisfied, an expense may not be deductible or may be deductible only in part, because all or part of the expense may have to be capitalized.²⁵ Thus, deductibility of an item depends upon notions of capitalization as well as the fixed and determinable nature of the payment obligation.

Even if the literal requirements of deductibility are met, the deduction for all or a portion of the face amount of the liability could nevertheless be subject to disallowance. Regulations Section 1.461-1(a)(2) has generally been read by courts and commentators to allow a deduction for the full amount of the liability,²⁶ although some courts have disallowed the deduction under certain

²⁴ IRC § 461(h)(4); Reg § 1.461-1(a)(2).

²⁵ Reg. § 1.461-1(a)(2) provides: “[A]ny expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred.”

²⁶ That rule has substantial case law support. For example, the court in *Lawyer’s Title Guar Fund v US*, 508 F2d 1 (5th Cir 1975), allowed a lawyers’ insurance fund using the accrual method of accounting to deduct the full amount of commissions for writing policies credited to individual lawyers and not normally payable for seven years. Moreover, the Service acquiesced and announced that it would follow that case. Rev Rul 77-266, 1977-2 CB 236.

In *Washington Post Co v US*, 405 F2d 1279 (Ct Cl 1969), the court also allowed deductions for accruals where future payment was not expected for several years and, indeed, the time of payment was uncertain. See also *Lukens Steel Co v Commr*, 442 F2d 1131 (3d Cir 1971). On the income side, the Supreme Court, in *Commr v Hansen*, 360 US 446 (1959), has required that automobile dealers accrue income in the full amount to be received even though payment of a portion would not be received for up to 60 months.

See also Rev Rul 69-429, 1969-2 CB 108, which involved an accrual-method partnership that was required to pay a workman’s compensation award to an injured employee for which it was liable under state law.

circumstances²⁷ and some commentators have suggested arguments in support of the position that the deduction could be allowed for less than the face amount of the liability.²⁸

Application of the accrual rule to interest deductions resulted in a substantial benefit to a debtor. For example, an accrual method taxpayer who owed interest for the current year for which payment was not due until sometime in the future, was entitled to a deduction in the amount of the accrued interest. In the example, interest for the first full year (assuming the purchase is made on January 1) amounted to approximately \$220,000 (9 percent of \$2,444,040). If the debtor was in the 50-percent marginal tax bracket, he would derive a \$110,000 tax benefit in the form of reduced income taxes from the interest accrual. If the accrued but unpaid interest did not result in additional interest because under the contract it was simple interest, the tax savings could very well have been invested by the debtor to fund payment of the entire liability. The accrued and deductible interest would then have resulted in no economic cost to the borrower at all.

To the extent that the accrued interest bears additional interest, however, the benefits to the borrower from this accrual rule will be reduced, and if that rate of "compound" interest is the market rate, the benefits will be eliminated. For example, if interest in the amount of \$220,000 were compounded at the market rate of interest, the tax and economic consequences to the borrower would be the same as if the interest were payable currently, and the bor-

²⁷ In *Mooney Aircraft, Inc v US*, 420 F2d 400 (5th Cir 1969), the court held that if payment was too far into the future, the deduction with respect to the future payment obligation would be disallowed. In *Mooney*, the court disallowed a deduction to an airplane manufacturer for the \$1,000 face amount of "Mooney Bonds" issued to airplane purchasers and payable to bearer on retirement of their airplanes. Retirement of an airplane and, therefore, payment of the bond was estimated at between 15 to 30 years in the future. The court sustained the Commissioner's use of discretion under IRC § 446(b) (clear reflection of income) because the liability to pay the bonds was so far into the future that (1) the relationship of the obligation of future payment to current income was attenuated, and (2) it could not be certain that the amount would ever be paid. The *Mooney* court took an all or nothing approach; because the payment date was so far in the future, no deduction was allowed. Presumably, if the payment date had not been so distant, the court would have allowed a deduction in the full amount of the bonds.

²⁸ See Goldberg, "Interest Elements in Tax Planning," *NYU Tax Institute: 1983 Conference on Tax Planning for the Individual* 129, 140-41 (1983).

rower borrowed additional money to pay that interest. In that event, the \$110,000 tax benefit from the interest deduction, if invested at the market rate of interest, could never equal the future cost of the \$220,000 loan because the amount of that loan would also be increasing based on the market rate of interest.

On the other hand, if there were no compounding or if the effective rate of compounding were lower than the market rate of interest, there will be substantial benefit derived by the borrower from taking advantage of the accrual rule for interest. In either event, the \$110,000 tax savings would be growing at the market rate of interest as a result of reinvestment. The loan amount representing the future liability for the accrued interest, however, would not be growing at all, in the case of no compounding, or would be growing at a slower rate, in the case of a lower effective interest rate.

[3] Objective 3: Noneconomic Interest Accrual

Prior to the enactment of TRA 1984, there was a statutory normative principle articulating how interest was earned, but that normative principle had only limited application. IRC Section 1232A, enacted as a result of TEFRA, provided for a method of determining how interest was earned on an obligation sold with OID. In general, as described earlier, OID arises when a debt obligation is sold by the issuer at a price ("issue price") less than the price at which the issuer will redeem the obligation at the end of its term ("redemption price"). The difference between the redemption price and the issue price is called OID. OID is considered earned by the holder over the life of the obligation, regardless of whether the holder uses the cash method or the accrual method.²⁹ Prior to TEFRA, OID was deemed earned under IRC Section 1232 on a straight-line basis—in equal amounts each month.³⁰

IRC Section 1232A, dealing with OID, and IRC Section 1232B, dealing with stripped coupon bonds, were enacted under TEFRA to change that result. Under those sections, OID was considered earned at a uniform rate of compound interest throughout the

²⁹ See text accompanying N 6, *supra*.

³⁰ IRC § 1232 (repealed by TRA 1984).

term of the obligation. In other words, a uniform rate of interest was determined by looking at the issue price, redemption price and term of an obligation issued with OID. That interest rate, in essence, was the rate at which an amount of money equal to the issue price would have to increase over the term of the obligation in order to yield the redemption price. That interest rate was called the "yield to maturity." In the first year, the amount of OID attributed to that year was computed by applying the "yield to maturity" determined on the basis of compounding at the close of each bond period to the issue price. For subsequent periods, the issue price was adjusted upward by adding previously included OID and the yield to maturity was applied to that amount (the "adjusted issue price"). Thus, using this method, more interest would be deemed earned in the later years of the obligation than in the earlier years.

In situations to which the statute did not apply, such as a promissory note (other than a marketable security) given for the purchase of property, the question of how interest was earned was left to case law and Service pronouncements. While the case law was at best inconclusive,³¹ the Service, in June 1983, finally ar-

³¹ For example, in *James Bros Coal Co v Commr*, 41 TC 917 (1964), the court said "in the absence of proof of any contrary arrangement between the lender and borrower . . . , the interest in respect of the borrower's single promissory note is deemed to accrue ratably over the entire period of said note." *Id* at 920-21. Further, in *Gunderson Bros Eng Corp v Commr*, 42 TC 419 (1964), *acq* 1967-2 CB 2, the court held that a finance charge on a note received in a dealer installment sale was earned ratably over the term of the note. In that case, the taxpayer used the sum of the years digits method that the court held clearly reflected income. However, the court specifically did not pass on the propriety of the taxpayer's method since it was not contested by the Service. *Id* at 427. The Service, rather, had sought to include the full amount of the finance charge in income at the time of the sale.

The Service also had failed to provide guidance prior to Rev Rul 83-84, 1983-1 CB 97. For example, in Rev Rul 72-100, 1972-1 CB 122, the Service recognized the Rule of 78's method of computing interest on installment loans as an acceptable method in the context of short term loans. In the situations dealt with in that ruling, the respective loans were for 12 and 60 months. Further, Rev Rul 74-607, 1974-2 CB 149, in "clarifying" that ruling, erroneously viewed the Rule of 78's as a method of applying the effective rate of interest to the unpaid balance of a loan. Rev Rul 79-228, 1979-2 CB 200, reiterated the Service's acceptance of the Rule of 78's in the context dealt with in Rev Rul 72-100, as "clarified" by Rev Rul 74-607. Finally, in Rev Rul 74-395, 1974-2 CB 46, the Service indicated that prepaid interest could be recovered through deductions

articulated its view on how interest was deemed earned, by issuing Revenue Ruling 83-84,³² dealing with interest accruals under the "Rule of 78's."

The Rule of 78's is a method of allocating the total amount of interest earned during the term of the loan among the periods of the loan. It operates in a manner similar to the sum of years digits method for computing depreciation. Under the Rule of 78's method, the amount of interest allocable to each taxable period is determined by multiplying the total interest payable over the life of the indebtedness by a fraction, the numerator of which is the number of taxable periods remaining on such indebtedness at the time the calculation is made, and the denominator of which is the sum of the periods' digits for the term of the indebtedness.³³ The Rule of 78's computation results in a greater proportion of interest allocated to the early periods of the loan than would otherwise be required by application of a uniform interest rate throughout the term of the loan, the method used in IRC Section 1232A.

In Revenue Ruling 83-84, the Service held that the Rule of 78's agreement did not define how interest actually was earned on the loan. Rather, it represented a purely mechanical formula for allocating interest among periods. Under the ruling, the Service reasoned that the amount of interest attributable to the use of

over the life of a loan under the Rule of 78's, if that method was provided for in the loan instrument.

The courts and the Service have held, however, that payments of interest at the inception of a loan in the form of points or otherwise are not deductible when paid. For example, in *Sandor v Commr*, 62 TC 469 (1974), *aff'd* 536 F2d 874 (9th Cir 1976), the court held that prepayment of five years' interest was not deductible under IRC § 446(b) because a deduction would distort the taxpayer's income. And in Rev Rule 74-607, the Service held that commitment fees or points paid at the inception of the loan are not deductible when paid, but rather are deductible ratably over the life of the loan.

³² 1983-1 CB 97.

³³ An illustration will be helpful in explaining how this method works. A five-year loan of \$100 earns aggregate interest of \$100 over five years. Under a generalized Rule of 78's method, the amount of interest allocated to year one would be computed as follows:

$$\frac{5}{1 + 2 + 3 + 4 + 5} \times \$100 = \frac{5}{15} \times \$100 = 33\frac{1}{3}$$

In fact, the Rule of 78's derives its name from the sum of the months' digits from 1 through 12, which equals 78.

money for a period between payments is determined by applying the "effective rate of interest" on the loan to the "unpaid balance" of the loan for that period. The effective rate of interest is a uniform rate over the term of the loan computed by reference to the amount borrowed and the repayment schedule. The effective rate of interest, when applied to the unpaid balance of the indebtedness for any period, produces the true cost of the indebtedness for that period, and that cost is referred to as the "economic accrual of interest" for that period. Accordingly, the Service held that only the amount of interest that economically accrues, computed by applying the effective rate of interest to the unpaid balance, will be deductible and no deduction for interest will be allowed for any year in excess of that amount.

Although the facts of Revenue Ruling 83-84 involved the Rule of 78's, the analysis and implications of the ruling were far broader. The ruling itself suggested that it would be extended. It provided as follows:

"Because interest is earned by application of the effective rate of interest over the term of the loan, any agreement that provides that interest is earned in another manner, such as under the Rule of 78's computation, lacks economic substance because it fails to reflect the true cost of borrowing."³⁴

Thus, the Service took a large step in supplying a normative standard for determining how interest was earned on a loan. Since the ruling, on its face, dealt specifically with the Rule of 78's, practitioners' questioned its scope and implications and its application to other methods of computing interest. For example, some practitioners questioned whether the Service would apply the ruling to the situation in the example involving a loan transaction that provided that interest would accrue at 9-percent simple, but would not be due until the end of the loan term. The broad language of the revenue ruling suggested that it would, but no further pronouncement emerged from the Service.

The example of the purchase of real property for a 15-year purchase money note in the principal amount of \$2,444,040, bear-

³⁴ 1983-1 CB 99.

ing interest at the rate of 9 percent per annum, simple interest, illustrates the front-loading of interest deductions. The combined use of the techniques of simple interest and accrued but unpaid interest effectively resulted in the interest being accrued on a noneconomic basis. For example, interest under the formulation based upon application of 9 percent to the principal amount of \$2,444,040 results in interest for the first year of \$219,960. However, if the effective rate of interest were computed on the note under the principles of Revenue Ruling 83-84, based on a uniform rate of compound interest over the life of the loan, that effective rate would be 5.78 percent, compounded semiannually. Applying that effective rate to the principal amount of the note for the first year yields an accrual of interest for that year of \$143,300, an amount substantially less than the result using 9 percent simple interest. The different interest amount in the early years of a loan between the application of simple interest and the economic accrual of interest results from the distortion caused by simple interest and the concept that in an economic bargain, a lender would not charge interest on interest.

[4] Objective 4: Deferral of Income and Change in its Character to Seller

Taxpayers used the technique illustrated by the hypothetical to accomplish the foregoing three objectives and satisfy the tax objectives of the seller as well. If the seller were a cash-method taxpayer, under the law prior to TRA 1984, the seller would have had no interest income until the interest amounts were received, regardless of how the interest amounts accrued.³⁵ Thus, the front-loading of interest deductions by the purchaser had no adverse effect on the cash method seller as long as payments of the accrued interest were not received.

In addition, the overstatement of the principal amount of the note and the understatement of interest, relative to the actual economic bargain between the parties, effectively converted income that would normally have been ordinary interest income to payment of principal on the note, and, therefore, sales proceeds. A seller of a capital asset in these transactions converted interest,

³⁵ Reg § 1.451-1(a).

which would have been taxed as ordinary income, to deferred payments of the sale price, which were treated as received on the sale or exchange of property, and therefore could be eligible for capital gain treatment. Under the installment sales rules of IRC Section 453, gain was deferred until receipt of the installment payments, and could be taxable preferentially as long-term capital gains (if the property were a capital asset or treated as such and the holding period requirement were met).³⁶ The seller derived the capital gain advantage regardless of his method of accounting.

§ 23.04 UNSTATED INTEREST AND ORIGINAL ISSUE DISCOUNT UNDER TRA 1984

[1] Overview

The four objectives could be accomplished because the tax law, prior to TRA 1984, dealt inadequately with the interest element in deferred payment transactions. Congress, in enacting TRA 1984, sought to remedy those inadequacies. It did so in two principal ways. First, it amended the imputed interest rules by requiring sellers to charge a market rate of interest on deferred payments. The required minimum rate was designed to adjust to changes in the market interest rates to insure that the interest rate would reflect a market interest rate for the specific type of obligation involved.³⁷ If the obligation bore a market rate of interest, it followed that the face amount of the note approximated its value. Second, Congress extended the application of the OID rules to notes issued in connection with the purchase of property, an area that had previously been specifically excepted from application of those rules.³⁸ Those changes were made through the enactment of IRC Sections 1274 and 1275 and the amendment of IRC Section 483. IRC Section 1274, in concept, combines the imputed interest rules of former IRC Section 483 with the OID rules of former IRC Section 1232A.

Importantly, however, in adopting an imputed interest rule

³⁶ IRC §§ 453 and 1221.

³⁷ See text accompanying N 46, *infra*.

³⁸ See former IRC § 1232(b)(2), which defined issue price as the stated redemption price if the bond was issued for property, except in certain enumerated circumstances.

concept similar to former IRC Section 483, Congress made significant modifications. Under the new statute, the safe harbor test rate floats with market rates and is computed on a compound rather than on a simple basis.³⁹ It is the latter element of former IRC Section 483, more than the below market safe harbor rate, that created opportunities for taxpayer distortion and abuse. In addition, new IRC Section 1274, by applying the OID rules, places both seller and purchaser on the accrual method of accounting with respect to the interest on the deferred payments.⁴⁰ This accrual rule would not apply to transactions involving imputed interest that are governed by IRC Section 483, as amended by TRA 1984, because they come within an exception to IRC Section 1274.⁴¹ Further, the new rules, both under IRC Section 1274 and IRC Section 483, allocate any imputed interest to time periods in the manner in which the interest accrues economically, rather than in proportion to the size of the deferred payments, as was done under former IRC Section 483.⁴²

Moreover, since the original effective date of the new enactments was to be January 1, 1985,⁴³ Congress enacted an interim rule for transactions taking place in 1984. That rule adopted the Service's position in Revenue Ruling 83-84, in effect, legislatively mandating the economic accrual of interest even if the parties had agreed on some other method of accruing interest, such as straight line, step interest, or the Rule of 78's.⁴⁴

In theory, the new imputed interest rules are designed to determine whether a portion of the stated principal amount of the purchase money debt is economically interest, that is, compensation for the seller having to wait a period of time to receive the deferred payments of the sale price. If it is determined that a portion of the principal amount of the indebtedness is in fact "unstated interest," then the statute provides a method to com-

³⁹ IRC § 1274(b)(2).

⁴⁰ IRC §§ 1272(a)(1) and 163(e)(1).

⁴¹ IRC § 483(a).

⁴² IRC §§ 1272(a)(1), 483(a).

⁴³ H Rep No 861, 98th Cong, 2d Sess 887-89 (1984), reprinted in 6B US Code Cong & Ad News 881-83 (Aug 1984).

⁴⁴ That position governs transactions occurring after June 8, 1984, but before Jan 1, 1985. *Id.*

pute how much of that principal amount is interest. Once that amount is computed, the provisions set forth rules for determining when that interest is regarded as earned and how it is allocated over the period of the loan.

The new sections providing rules for unstated interest and OID evidence the policy judgment, as did former IRC Section 483, that deferral of payments for a relatively short period should not trigger the complications necessarily brought on by the rules. Therefore, under the new statute, the imputed interest rules and OID rules are applied to purchases of property involving payments due more than six months after the date of sale or exchange.⁴⁵

[2] The Mechanics and Application of IRC Section 1274

The application of the unstated interest rules to purchase money debts proceeds in essentially a three-step process. First, one must determine the present value of the debt instrument by discounting all of the payments to be made under the instrument (both principal and interest) by 110 percent of the applicable federal rate. Applicable federal rate is a defined term in the statute.⁴⁶ Its use as a basis for a discount factor represents an attempt to use the interest rate for federal obligations as a benchmark for the market rate of interest of like term private debt obligations. Since no private debt obligation is likely to be as safe as a debt obligation issued by the federal government, the test rate is set at a rate above that of the federal rate, to account for the greater risk. The present value of the debt obligation, computed in this manner, is called the “imputed principal amount” or the “testing amount.”⁴⁷

Second, one must compare the “stated principal amount” of the debt obligation with the testing amount.⁴⁸ The stated principal amount of the debt obligation is simply the principal amount

⁴⁵ IRC § 1274(c)(1)(B). The provisions also contain a *de minimis* rule, in effect, excepting from their application obligations with very small amounts of OID. If the OID is less than (1) 0.25 percent of the stated redemption price at maturity, multiplied by (2) the number of complete years to maturity, then the OID shall be treated as zero. IRC § 1273(a)(3).

⁴⁶ See IRC § 1274(d).

⁴⁷ IRC § 1274(c)(3) and (b).

⁴⁸ IRC § 1274(c).

stated in the obligation and does not include any of the interest which will accrue and be deferred. If the stated principal amount of the obligation is greater than the testing amount, that means that the debt instrument is not worth as much as its stated amount, because it bears too little interest. To illustrate, if the debt instrument bore a rate of interest equal to the assumed market rate for that obligation (110 percent of the applicable federal rate) then its present value (testing amount), using the discount factor of 110 percent of the applicable federal rate, would be equal to the stated principal amount of the obligation. However, if the stated principal amount were greater than the testing amount, that would occur because the obligation bore a rate of interest less than its assumed market rate. As a result, a portion of the stated principal amount would represent unstated interest because it would be a payment to be received by the seller as compensation for waiting for the deferred payments, rather than as payment for the property itself. That does not mean, however, that the statute simply treats the excess of the stated principal amount over the testing amount as unstated interest. Rather, the determination of the amount of unstated interest requires an additional step.

The third step, which is the determination of the amount of unstated interest, is similar to the second step. If the test in step two is failed because there is not adequate stated interest, the issue price is the "imputed principal amount"⁴⁹ of the obligation rather than the stated principal amount. However, that imputed principal amount is not computed in precisely the same way as the imputed principal amount (testing amount) was computed in step two. Rather, when determining the amount of unstated interest, rather than merely testing for it, the imputed principal amount is equal to the present value of the debt instrument, discounting all payments by 120 percent of the applicable federal rate (rather than by 110 percent of the applicable federal rate which is used for testing purposes only). That present value discount factor, like the discount factor used for testing purposes, is a rate of interest compounded semiannually.⁵⁰ Thus, the unstated interest amount of the obligation is determined by the difference between the

⁴⁹ IRC § 1274(a)(2).

⁵⁰ IRC § 1274(b)(1) and (2).

stated principal amount of the obligation and the imputed principal amount.

The computations in both steps two and three are based upon the applicable federal rate as of the first day on which there is a binding contract in writing for the sale or exchange.⁵¹ As indicated previously, the applicable federal rate is intended to operate as a benchmark for computing a market rate of interest on a private debt obligation. Since interest rates typically vary with the term of the obligation, Congress created three possible applicable federal rates.⁵² The first is a short-term rate, applicable to obligations with a term shorter than three years. The second is a mid-term rate, applicable to obligations with a term longer than three years but shorter than nine years. The third is a long-term rate, applicable to obligations of a term longer than nine years. Under the statute, the Service is instructed to publish rates for the three categories every six months, two and one-half months prior to the effective date of the rate.⁵³ The rates published are to be based upon the six-month period beginning nine months prior to the effective date and ending three months prior to the effective date.⁵⁴ Thus, the rates effective for January 1, 1985 were set on October 15, 1984, and were based upon the average market yield of the appropriate term federal obligations for the six months ending September 30, 1984.⁵⁵

The three-step procedure outlined above determines how much of the stated principal amount of an obligation economically represents interest rather than sales proceeds. The statute treats the unstated interest as OID. In addition, interest that accrues but is not payable currently is also treated as OID. The treatment of both of those components as OID is accomplished in the following manner. OID is equal to the difference between the "stated redemption price at maturity" of the obligation and the "issue price."⁵⁶ Stated redemption price at maturity is defined to mean,

⁵¹ IRC § 1274(d)(2).

⁵² IRC § 1274(d).

⁵³ IRC § 1274(d)(1)(B).

⁵⁴ *Id.*

⁵⁵ Those rates were actually published later than Oct 15, 1984, in Rev Rul 84-163, 1984-47 IRB 25.

⁵⁶ IRC § 1273(a)(1).

in substance, all amounts (including both interest and principal) payable at maturity, "other than any interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of one year or less during the entire term of the debt instrument."⁵⁷ If there is adequate stated interest, that is, if the test in step two is passed, issue price is defined as the stated principal amount of the obligation.⁵⁸ As a result, where there is adequate stated interest, OID is defined as the excess, if any, of the stated redemption price at maturity over the stated principal amount of the obligation.

If there is unstated interest because the test in step two was failed, the amount of the unstated interest (computed in step three) is the excess of the stated principal amount of the obligation over the imputed principal amount. That excess is included in the OID of the obligation along with the accrued interest portion of the obligation, because OID is defined, in cases where there is unstated interest, as the stated redemption price at maturity minus the imputed principal amount.

IRC Section 1272 provides rules for determining how OID, both resulting from unstated interest and accrued but unpaid interest, is deemed earned. In that sense, the statute fills a gap which had been exploited in the case of purchase money obligations for which no statutory rule had been provided prior to TRA 1984. In substance, the OID interest is deemed to accrue as it accrues economically, by application of the same principal adopted by the Service in Revenue Ruling 83-84. Where all of the OID results from unstated interest, the "yield to maturity," a uniform rate of interest applicable over the term of the loan, will equal 120 percent of the applicable federal rate. That rate, when applied to the present value of the debt obligation, will determine the amount of interest allocable to the initial accrual period. The sum of the amounts payable as interest on the debt instrument during that accrual period, if any, is then subtracted from the interest deemed earned during the accrual period to determine the amount of OID that in fact has been earned during that period.⁵⁹ That amount is then added to the present value of the

⁵⁷ IRC § 1273(a)(2).

⁵⁸ IRC §§ 1273(b)(4) and 1274(a)(1).

⁵⁹ IRC § 1272(a)(3).

obligation (called the issue price) in order to determine the “adjusted issue price” for the next accrual period.⁶⁰ For these purposes, the term of the loan is divided into six-month intervals with the last six months ending on the maturity date of the instrument. These intervals are called accrual periods.⁶¹ Each accrual period is six months except possibly the initial accrual period. For each succeeding accrual period, the yield to maturity is applied to the adjusted issue price at the beginning of the period, from which is then subtracted the interest payable as determined by the instrument during the accrual period in order to determine the amount of OID allocable to that accrual period. Thus, under this procedure, the amount of interest is computed on a daily basis,⁶² with the interest for each six-month accrual period equal to the increase in the instrument’s adjusted issue price.⁶³ These increases each period ensure that all the OID will be accounted for by the time of the instrument’s maturity.

[a] *General Effects of New Provisions*

Taken together, the provisions essentially have three effects. First, the use of a new, generally higher, testing rate of interest instead of the 9-percent rate of simple interest formerly applicable to deferred payments under former IRC Section 483, recasts stated principal amount or purchase price into unstated interest and treats it as interest. Second, the mechanics of the OID rules provide that all of the interest on the obligation, whether or not there is unstated interest, will be deemed to accrue economically in accordance with the application of a uniform rate of interest over the life of the loan. Third, and perhaps of least importance but representing the greatest conceptual change in the new law, the buyer/debtor and the seller/lender both account for the interest element in the transaction, whether stated or unstated, under the accrual method of accounting, regardless of the method of accounting which either of them normally employs. Thus, the buyer/debtor deducts interest as it accrues, that is, as the OID is allocated among the accrual periods, regardless of his method of

⁶⁰ IRC § 1272(a)(4).

⁶¹ IRC § 1272(a)(5).

⁶² IRC § 1272(a)(1).

⁶³ IRC § 1272(a)(4).

accounting. Moreover, the seller/lender includes in income the portion of the OID allocable to the accrual period as well, regardless of whether or not he actually receives interest payments and regardless of his method of accounting.

The third aspect of the new law, mandating accrual accounting for interest on a sale, represents a substantial departure from prior law, governed by former IRC Section 483. That treatment is also different from the treatment accorded transactions governed by IRC Section 483, as amended, as those transactions come within an exception under IRC Section 1274 to the new OID rules. Under IRC Section 483, both before and after its amendment by TRA 1984, the methods of accounting of the buyer and the seller are important. If there is no unstated interest under IRC Section 483, the taxpayer's method of accounting will govern his treatment of the interest. If, however, there is unstated interest in the transaction, that unstated interest will generally be treated under the cash method of accounting.⁶⁴ In that connection, the unstated interest is accounted for by both buyer and seller when the interest payments are made, in the case of a cash-method buyer or seller, or when the interest is due, in the case of an accrual method buyer or seller.⁶⁵ As long as payments are made when due, even if deferred under the terms of the purchase agreement, cash-method and accrual-method sellers and buyers, as the case may be, are treated alike.

[b] *Effect on Tax Objectives*

Returning to the example set forth previously which illustrated how the four tax objectives could be accomplished under prior law, one can see how TRA 1984 affects that transaction. Under the hypothetical, the buyer purchased real property from the seller giving the seller a promissory note in the principal amount of \$2,444,040, bearing the interest at the rate of 9-percent simple, with all interest and principal payable at the end of the 15-year term of the note.

⁶⁴ IRC § 483(a).

⁶⁵ Reg § 1.483-2(a)(1)(ii) (issued prior to amendment of IRC § 483 by TRA 1984).

[i] *Objective 1: Increasing Basis*

Under the unstated interest portion of the new rules, the imputed principal amount of the note, and therefore the amount treated as the purchase price of the property, will be the present value of the note, computed by using a discount rate equal to 120 percent of the applicable federal rate. That is the applicable rule unless the stated rate of interest is at least 110 percent of the applicable federal rate. It should be assumed that with an applicable federal rate of 10 percent compounded semiannually, the promissory note described in the example will fail the unstated interest test and will therefore be subject to the corrective provision. The imputed principal amount of the note will determine the basis of the property in the hands of the purchaser.

The imputed principal amount of the note will be computed using a discount rate of 12 percent compounded semiannually (120 percent of the applicable federal rate). The imputed principal amount on the note in the example is equal to \$1 million.⁶⁶ Thus, the basis of the property in the hands of the purchaser is only \$1 million, rather than the inflated stated principal amount of the note of \$2,444,040.

[ii] *Objectives 2 and 3: Interest Deduction for Full Accrual and Determining That Amount*

Under the unstated interest rule, the purchaser's interest deduction will be limited in any accrual period to the amount determined by applying 120 percent of the applicable federal rate (the yield to maturity) to the imputed principal amount of the debt, as adjusted from accrual period to accrual period. The amount of OID allocable to an accrual period is the amount of the interest deduction, less interest actually paid during the period.

Since in the example, no interest is paid currently, all of the interest deduction to the purchaser will be attributed solely to the allocation of the OID of the obligation to the appropriate period. Thus, the purchaser's interest deduction for the first year (assum-

⁶⁶ That amount is the present value of the total amount of payments (\$5,743,494), including principal (\$2,444,040) and interest (\$3,299,454) due at the maturity of the obligation, using a discount factor of 12 percent compounded semiannually. See N 15, *supra*.

ing a starting date of January 1st on the obligation) will be \$123,600. That amount is computed by applying the appropriate rate (12 percent compounded semiannually) to the imputed principal amount of the obligation (the issue price), \$1 million. The interest deduction of \$123,600 is substantially smaller than the interest deduction allowable under pre-TRA 1984 law, \$219,960, which was determined by applying the stated rate of interest, 9 percent, to the stated principal amount of the obligation, \$2,444,040. The interest deduction allowable under the new rules is also substantially less than the amount that would have been allowable under the pre-TRA 1984 rules, even after application of the economic accrual of interest rules provided in Revenue Ruling 83-84. That amount would have been \$143,300, computed by applying the effective rate of interest (the compound interest rate equivalent to 9-percent simple interest for 15 years, i.e., 5.78 percent compounded semiannually) to \$2,444,040, the stated principal amount of the debt obligation.

[iii] *Objective 4: Treatment of the Seller*

Finally, the new rules substantially change the treatment of the transaction by the seller. First, the seller will be taxable on the applicable portion of the OID from the debt obligation each accrual period, regardless of whether he actually receives that amount and regardless of his method of accounting. Thus, the seller in the hypothetical will be required to include \$123,600 of interest in income during the first year of the obligation, whereas under prior law if he had been using the cash method of accounting he would not have had to include any amount in income during the first year.

Second, when the seller ultimately receives payment on the debt obligation, the amount realized by him on the sale for purposes of computing his capital gain will consist only of the imputed principal amount or issue price of the obligation, rather than the full stated principal amount of the obligation. Consequently, he will have a substantially smaller capital gain to report. That consequence is a result of having been required to report the excess of the stated principal amount of the obligation over the imputed principal amount (the OID) as interest income over the 15-year term of the obligation.

[3] Tax Policy Implications

With painstaking efficiency and technical complexity, the new rules force both buyer and seller to report the transaction in accordance with its economic realities. Further, by virtue of the floating benchmark supplied by the adjustable applicable federal rate, Congress has assured itself that the rules will automatically keep pace with a changing economic environment and changing interest rates. Moreover, by effectively placing both buyer and seller on the same method of accounting, the government cannot be whipsawed by a taxpayer on one side of the transaction obtaining a deduction without a corresponding income inclusion by a taxpayer on the other side of the transaction (as long as the recipient is a taxpaying entity). Thus, the question must be asked, what more could any tax policy analyst want from a series of income tax provisions? To suggest an answer to that question, one must first work through other details of the statute.

[4] Exceptions to IRC Section 1274 and Special Rules

In subjecting purchases of property for purchase money debt to the new unstated interest and OID provisions and, in particular, to the stricter requirements of charging market rate interest, Congress decided to create various exceptions for traditionally favored transactions or to accomplish other tax policy objectives. In particular, IRC Section 1274 contains exceptions for the following types of transactions:⁶⁷

- (1) sale of a farm for less than \$1 million by an individual, estate, trust or small business corporation (under IRC Section 1244(c)(3)) or certain partnerships (those that meet the requirements of IRC Section 1244(c)(3));
- (2) sales by an individual of his principal residence (as defined in IRC Section 1034);
- (3) sales involving total payments (including principal and interest on the debt instrument and all other consideration to be received on the sale or exchange) not exceeding \$250,000;
- (4) debt instruments which are publicly traded or are issued for publicly traded property;⁶⁸

⁶⁷ IRC § 1274(c)(4).

⁶⁸ See IRC § 1273(b)(3).

- (5) debt instruments received on a sale or exchange of a patent (IRC Section 1235(a)) which contains an amount contingent on the productivity, use or disposition of the property transferred; and
- (6) any debt instrument to which IRC Section 483(e) applies (dealing with land transfers between related parties).

Furthermore, Congress also created an exception for loans for personal use.⁶⁹ In that connection, IRC Sections 1274 and 483 do not apply to the borrower in the case of any debt instrument given in consideration for the sale or exchange of "personal use property" (i.e., property, substantially all of the use of which by the taxpayer is for other than trade or business or income-producing purposes, determined at the time the instrument is issued).

Also, special rules are provided in the case of certain cash-method obligors. OID is deductible only when paid in the case of a debt instrument having OID (determined after application of IRC Section 1275(b)(1)) that is issued by a cash-method taxpayer in connection with the acquisition or carrying of personal use property.⁷⁰

Finally, short-term obligations involving cash-method taxpayers are also subject to some special rules. In general, a noteholder must include in income the applicable portion of OID.⁷¹ There is an exception for short-term obligations having a fixed maturity date not more than one year from date of issuance.⁷² That exception, however, is not applicable to an accrual-method holder.⁷³

A special rule applies on the debtor's side as well. The rule allowing periodic deduction of OID⁷⁴ is not applicable to issuers of short-term obligations reporting income on the cash method.⁷⁵

⁶⁹ IRC § 1275(b)(1).

⁷⁰ IRC § 1275(b)(2).

⁷¹ IRC § 1272(a)(1).

⁷² IRC § 1272(a)(2)(C).

⁷³ IRC § 1281(b)(1)(A).

⁷⁴ IRC § 163(e)(1).

⁷⁵ See HR Rep No 861, N 43, *supra*, at 887.

[5] Application of Revised IRC Section 483

IRC Section 483 will continue to apply to sales and exchanges that are within one of the exceptions to the unstated interest OID rules of IRC Section 1274. However, that section also has been substantially revised. Where IRC Section 483 applies, unstated interest income and expense will be computed on an economic accrual basis, in accordance with the principles of IRC Section 1272 and Revenue Ruling 83-84.⁷⁶ However, in the case of a cash-method taxpayer, such amounts will be reported only when payment is made or, in the case of an accrual-method taxpayer, when payment is due.⁷⁷ Further, the section applies an unstated interest rate of 120 percent of the applicable federal rate (determined under IRC Section 1274(c)), applied, like that section, on a semiannually compounded basis.⁷⁸ Similar to IRC Section 1274, the testing rate is 110 percent of the applicable federal rate. Unlike pre-TRA 1984 IRC Section 483, however, the testing rate is applied on a semiannually compounded basis, rather than on a simple basis.⁷⁹

IRC Section 483 also contains the traditional exceptions and modifications. It excludes from coverage sales or exchanges by an individual of his principal residence for a purchase price under \$250,000 and sales or exchanges by a person of land used for farming.⁸⁰ Rather, the imputed interest rules of former IRC Section 483 will apply. For example, the old testing rate of 9-percent simple and unstated interest rate of 10 percent compounded semiannually will apply to the sale of a taxpayer's principal residence that falls within the exception. It also contains exceptions for sales for \$3,000 or less⁸¹ and for sales of certain patents.⁸²

⁷⁶ IRC § 483(a).

⁷⁷ See Reg § 1.483-2(a)(1)(ii) issued under IRC § 483 prior to its amendment by TRA 1984.

⁷⁸ IRC § 483(b).

⁷⁹ IRC § 483(c).

⁸⁰ IRC § 483(e).

⁸¹ IRC § 483(d)(2).

⁸² IRC § 483(d)(4).

[6] Other Special Rules

Finally, in the original enactment of the new provisions, Congress sought to deal with various special problems involving potentially abusive situations, understatements rather than overstatements of purchase price, attempts to avoid the provisions by using the more favorable rules relating to below market interest loans, and to deal with the problems involving floating interest rates. Some of those special rules were contained within the statute itself, and some are evidenced only in the committee reports to the statute.

[a] *Potentially Abusive Situations*⁸³

In the case of a "potentially abusive situation," the imputed principal amount of a debt instrument received in exchange for property shall be the fair market value of the property. Potentially abusive situations include tax shelters⁸⁴ or other situations specified in regulations to be issued. Examples include situations involving recent sales transactions, nonrecourse financing, or financing with a term in excess of the economic life of the property.

This provision appears to be especially directed at situations in which property is purchased for a nonrecourse note with a principal amount exceeding the value of the property. In those situations, taxpayers seek to obtain a basis in the purchased property equal to the principal amount of the note, which is likely an amount exceeding the value of the property. Unlike the situation directly dealt with by the unstated interest rules, however, the excess value of the principal amount of the note over the value of the property does not result from an understatement of the interest rate of the note.

The Service's principal attack on these transactions has been to consider the purchase money note to be a contingent rather than an actual liability of the purchaser, and therefore to be excluded from the purchaser's basis until paid.⁸⁵ Resolution of whether the

⁸³ IRC § 1274(b)(3).

⁸⁴ Reference is made to the definition of "tax shelters" in IRC § 6661(b)(2)(C)(ii).

⁸⁵ See, e.g., *Est of Franklin v Commr*, 544 F2d 1045 (9th Cir 1976).

liability should be regarded as an actual liability includable in the purchaser's basis would seem to depend upon whether the purchaser is likely to pay off the note and that event, in turn, would seem to depend both upon the value of the property at the time of purchase and the expected value of the property at the time the note is due.⁸⁶

The statute, then, recognizes that its primary provisions involving unstated interest and OID will not solve the overstated basis problem in situations in which the overstated basis results from a nonrecourse purchase money note bearing a rate of interest satisfying the testing rate of the statute. Accordingly, Congress attempted to limit the purchaser's basis to the fair market value of the property. That position seems to be more lenient than the case law, which would deny a taxpayer basis for the note bearing a market rate of interest if the principal amount of the note substantially exceeded the value of the property.⁸⁷

[b] *No Preemption by IRC Section 1274 of Service Authority to Reallocate to Principal*

In addition to empowering the Service to recharacterize principal as unstated interest, the committee reports indicate that the Service "retains the right to challenge a transaction in which the principal amount of an obligation is *less* than the fair market value of the property received in exchange for the obligation."⁸⁸ Thus,

⁸⁶ See Rev Rul 84-5, 1984-1 CB 32.

⁸⁷ TRA 1984 § 44(b)(3) made the fair market value rule (codified in IRC § 1274(b)(3)) effective, generally, for any sale or exchange after Mar 1, 1984, and before Jan 1, 1985, the general effective date of the new OID provisions. That effective date raises a question whether the stated principal amount of a nonrecourse purchase money note issued between those dates (not pursuant to an earlier binding contract) that satisfies the pre-1985 safe harbor test rate of 9 percent per annum simple interest and which provides for accrued interest will be includable in the basis of the property at its full amount or only at its present value. If the answer is present value, how will the excess of the face amount over the present value be accounted for, since the applicability of the OID provisions to that amount is not prescribed for pre-1985 transactions? Moreover, how can that provision be reconciled with pre-1985 IRC § 483, which generally provides a safe harbor from the unstated interest rules for the note described above? It appears that there is an internal inconsistency within the statute for those transactions.

⁸⁸ See HR Rep No 861, N 43, *supra*, at 888.

for example, the Service could prevent taxpayers from overstating interest or OID to reduce basis in nondepreciable property in order to overstate interest deduction.

[c] *Interaction of Sale With Low Interest Loan*

In some situations, it could prove advantageous for a purchaser of property to structure his purchase as a cash purchase, for which he obtained financing by means of an "unrelated" loan from the seller. In that manner, the purchaser and the seller could provide for an interest rate equal to the applicable federal rate, in order to satisfy the low-interest loan provisions of IRC Section 7872, rather than the testing rate of 110 percent of the applicable federal rate, the requirement under IRC Section 1274. The committee reports make it clear that a loan complying with low-interest loan interest provisions made from the seller and used to purchase the seller's property nevertheless will be treated as a purchase money note subject to the unstated interest rules of IRC Section 1274.⁸⁹

[d] *Floating Rate*

Finally, the committee reports indicate that a debt instrument bearing a floating rate of interest pegged to 110 percent of federal short-term rate, adjustable at no more than six-month intervals, will not give rise to OID.⁹⁰

[7] **Effective Dates and Interim Congressional Action**

[a] *Effective Dates*

As originally enacted, the unstated interest and OID rules of IRC Section 1274 generally were to apply to transactions entered into after December 31, 1984, with certain transactions occurring after that date made pursuant to a written contract (including an option contract) in effect on March 1, 1984, being excluded. However, the provisions prescribing the economic accrual of interest were made effective for transactions occurring after March 1, 1984, and before January 1, 1985, even though the testing rate and

⁸⁹ See *id* (Clarifications of Intent).

⁹⁰ See *id* at 889 (Clarifications of Intent).

imputed interest rate of former IRC Section 483 were still applicable to pre-1985 transactions.⁹¹

[b] *Interim Congressional Action*

Before the ink on those provisions was dry, however, Congress agreed to modify them and enacted HR 5361 (hereinafter the "Revision").⁹² Most important, under the Revision, the new provisions enacted under TRA 1984 were retained through June 30, 1985, with certain significant modifications.

[i] *Blended Interest Rates*

Under the Revision, transactions involving seller financing of \$2 million or less will be subject to less harsh imputed interest requirements, and transactions involving more than \$2 million of seller financing will receive part of this more lenient treatment, that part attributable to the first \$2 million of the debt. In particular, in the case of any sale or exchange before July 1, 1985, of property other than new Section 38 property, the testing rate for imputed interest for transactions involving \$2 million or less of seller financed debt is 9 percent, compounded semiannually.⁹³ Failure to state adequate interest will result in imputed interest at the rate of 10 percent compounded semiannually.⁹⁴

For transactions involving a borrowed amount exceeding \$2 million, a blended testing rate and imputed interest rate is used. The blending is derived, in substance, by taking a weighted average of, in the case of the testing rate, 9 percent and 110 percent of the applicable federal rate. The weighting for computing this average is based upon a ratio between the first \$2 million of debt, which carries the 9-percent rate, and the amount of the debt in excess of \$2 million, which carries the rate of 110 percent of the applicable federal rate.⁹⁵ A similar computation scheme is used in

⁹¹ See *id* at 887-88, and Rev Rul 84-163, 1984-47 IRB 25.

⁹² Pub L No 98-612, 98th Cong, 2d Sess (Oct 31, 1984). That statute, introduced into Congress as HR 5361, amended TRA 1984 § 44(b), which related to the effective date for treatment of debt instruments issued for property.

⁹³ TRA 1984 § 44, as amended by § 2 of HR 5361 (hereinafter cited as "Revision"), § (4)(A) and (B).

⁹⁴ Revision, N 93, *supra*, ¶ 4(A) and (C).

⁹⁵ *Id* ¶ 4(B).

computing the amount of imputed interest, using the 10-percent imputed interest rate for the first \$2 million portion and 120 percent of the applicable federal rate for the excess over \$2 million, and weighting those rates in the same manner as the testing rates are weighted.⁹⁶ For purposes of making those computations, all sales or exchanges which are part of the same transaction (or a series of related transactions) are to be treated as one sale or exchange, and all debt instruments arising from the same transaction (or a series of related transactions) are to be treated as one debt instrument.⁹⁷

The Revision also provides special interim rules for sales of property used in farming. In the case of any sale or exchange before July 1, 1985, of property (other than new Section 38 property) used in the active conduct of farming and in which the stated principal amount of the purchase money debt does not exceed \$2 million, the imputed interest rules of IRC Section 1274 will not apply.⁹⁸ In addition, interest on those obligations issued in connection with such sale or exchange shall be taken into account by both buyer and seller on the cash receipts and disbursements method of accounting.⁹⁹ For those transactions, therefore, rules substantially the same as IRC Section 483, as amended, should apply, although the application thereof is not specifically set forth in the new provision.

[ii] *Debt Assumptions*

Finally, the Revision clarified the treatment of debt assumptions. It provides that the new unstated interest and OID rules generally apply to debt obligations of the purchaser assumed in connection with the sale or exchange of property or to which acquired property is taken subject.¹⁰⁰

⁹⁶ *Id.* ¶ 4(C).

⁹⁷ *Id.* ¶ 4(E).

⁹⁸ *Id.* ¶ 4(F)(i).

⁹⁹ *Id.* ¶ 4(F)(ii).

¹⁰⁰ The Revision provides as follows:

“Except as provided in paragraphs (6) and (7), if any person

“(A) assumes, in connection with the sale or exchange of property, any debt obligation, or

“(B) acquires any property subject to any debt obligation,

Treasury's perceived need to apply the new rules to debt assumptions emanated from its view that the new statute was intended to limit the basis of property to its value. Treating an old and therefore low-interest debt that was assumed by the purchaser as a cash payment by the purchaser could give rise to substantial abuse. Allowing that treatment for purposes of IRC Section 1274 would result in applying the unstated interest testing rules to the new purchase money mortgage only. A purchaser would thereby satisfy the test rate and have a basis in the property greater than its fair market value; the purchaser would obtain basis credit for the full face amount of the existing mortgage even though his assumption of the mortgage represented the giving of value in an amount less than the face amount of the assumed debt.

Prior to the enactment of the Revision, the treatment of debt assumptions was in doubt, although Treasury had indicated that it would seek to apply the new imputed interest rules to debt assumptions. As originally enacted, IRC Section 1274 was silent as to whether the imputed interest rules would apply to debt assumptions. There was support in the statute for concluding that a preexisting debt assumed by a purchaser or to which the property acquired was taken subject should not be considered a debt given in consideration for the sale or exchange of property within the meaning of IRC Section 1274. There were indications contained both in the statute and in the committee reports, however, that the section was intended to apply to debt assumptions.¹⁰¹

Sections 1274 and 483 of the Internal Revenue Code of 1954 shall apply to such debt obligation by reason of such assumption (or such acquisition)." *Id.* ¶ 5.

¹⁰¹ In addition, IRC § 1274(c) expressly provides that the section "shall apply to any debt instrument given in consideration for the sale or exchange of property. . . ." Under the statute, the Treasury was given extremely broad regulation authority, and that authority extended to the treatment of assumptions of debt instruments. IRC § 1275(d) provides as follows:

"Regulation Authority.—The Secretary may prescribe regulations providing that where, by reason of varying rates of interest, put or call options, indefinite maturities, contingent payments, *assumptions of debt instruments*, or other circumstances, the tax treatment under this subpart (or Section 163(e)) does not carry out the purposes of this subpart (or Section 163(e)), such treatment shall be modified to the extent appropriate to carry out the purposes of this subpart (or Section 163(e))." [emphasis added]

In substance, the broad regulatory authority granted to the Treasury under IRC § 1275(d) would seem to have permitted the Treasury to impose the imputed

Although the Revision clarified the matter by generally applying the unstated interest and OID rules to debt assumptions, it provided several exceptions to the general rule. First, the unstated interest and OID rules do not apply to debt assumptions or obligations to which property is taken subject in cases in which the debt obligations were issued on or before October 15, 1984, unless the terms and conditions of those debt obligations were modified in connection with the assumption (or acquisition).¹⁰² Although, under a literal reading of the statute as enrolled, that exception would only apply if the sales price is \$100 million or more, it is clear that congressional intent was to allow that exception to apply

interest rules on debt assumption transactions as well as newly created debt instruments.

Also, the committee reports to the sections contemplated application of the imputed interest rules to debt assumptions. The Conference Committee Report to TRA 1984 provided as follows:

"Finally, the conferees anticipate that the Commissioner will issue regulations, similar to the regulations under existing section 483, dealing with the tax consequences of debt obligations which are assumed or taken subject to, that is, the transfer of obligations to make or rights to receive deferred payments subject to the OID rules. The conferees intend that such rules apply not only to the assumption of deferred payment obligations, but also to assumptions of obligations to third-party lenders. *These rules will apply to sales and exchanges after December 31, 1984, and therefore will apply to debt obligations that are assumed or taken subject to after that date even though such obligations were first issued prior to that date.*" [emphasis added] HR Rep No 861, N 43, *supra*, at 889.

IRC § 483, on the other hand, prior to its amendment by TRA 1984, generally treated debt assumptions by the purchaser as payment in cash. In particular, the regulations under IRC § 483 provided that in determining whether there was unstated interest, "the assumption by the transferee of the obligation of the transferor shall be treated as a payment made at the time of transfer." Reg § 1.483-1(f)(6)(i)(d). Moreover, that rule applied regardless of whether the transferor of the property was released from the liability. If the underlying obligation that was assumed or to which the property was taken subject contained an unstated interest component, the purchaser of the property who assumed the obligation or took the property subject to it essentially stepped into the shoes of his vendor. That purchaser deducted unstated interest and did not include in basis that interest portion. Further, the treatment of the debt assumption as a cash payment by the purchaser was consistent with the wraparound regulations under IRC § 453, dealing with installment sales in which the purchaser gave a wraparound note to the seller, who remained liable on the underlying mortgage. Temp Reg § 15A.453-1(b)(3)(ii).

¹⁰² Revision, N 93, *supra*, ¶ 6.

to cases in which the sale price was no greater than \$100 million.¹⁰³

Second, exceptions are also provided for assumptions of loans and loans to which property is taken subject with respect to certain types of property.¹⁰⁴ The section will not cover those debt obligations (unless the terms and conditions of such debt obligations are modified in connection with the assumption (or acquisition)) in the following types of transactions:

- (1) *Residence*. Any sale or exchange of a taxpayer's residence which either was the principal residence of the taxpayer, or a residence (such as a vacation home) if the residence was used only for personal purposes so that no substantial part of the home was subject to an allowance for depreciation.¹⁰⁵
- (2) *Farms*. In general, any sale or exchange by an individual or certain other classes of taxpayer ("qualified person") of real property or used personal property, if the property (real or personal) was sold for use in the active conduct of the trade or business of farming by the transferee of the property.¹⁰⁶
- (3) *Trades or businesses*. Any sale or exchange by a qualified person of any trade or business, as described in the section (which specifically excludes new Section 38 property).¹⁰⁷
- (4) *Business real estate*. Any sale or exchange of any real estate used in an active trade or business by a "qualified person" defined for these purposes with some modifications. In this connection, the term active trade or business does not include the holding of real property for rental.¹⁰⁸

¹⁰³ See "This Week's Tax News," *Tax Notes* 389 (Oct 29, 1984).

¹⁰⁴ Revision, N 93, *supra*, ¶ 7.

¹⁰⁵ *Id* ¶ 7(B)(i).

¹⁰⁶ *Id* ¶ 7(B)(ii).

¹⁰⁷ *Id* ¶ 7(B)(iii).

¹⁰⁸ *Id* ¶ 7(B)(iv). *Id* ¶ 7(C)(i) defines "Qualified Person" as follows:

"(I) a person who—

"(aa) is an individual, estate, or testamentary trust,

"(bb) is a corporation which immediately prior to the date of the sale or exchange has 35 or fewer shareholders, or

The foregoing exceptions are applicable without regard to the date on which the debt obligation arose.

The application of the imputed interest rules to debt assumptions also raises questions regarding the treatment and application of those rules to the holder of that debt instrument. It is mechanically possible to apply the imputed interest rules to the overall purchase and thereby create an unstated interest portion in the existing mortgage which the purchaser assumed or to which the property was taken subject. In that event, would the holder of the note be required to include the newly created unstated interest portion of the old debt obligation in income as OID over the term of the note? Such a result would be indeed surprising to the noteholder and, it would appear, unfair to him as well, since at the time the noteholder obtained the note, there presumably was no OID portion. It is theoretically possible under these rules to apply the unstated interest and OID rules to the debtor only and thereby create interest deductions for the purchaser without any corresponding interest income to the holder of the note. It would appear that this latter approach would be the more likely one to be adopted by the Treasury.

[iii] *Wraparound Notes*

Closely connected with assumed debt is the treatment of wraparound notes. It should be supposed that the purchaser does not assume the existing mortgage liability, but rather wraps his note around it. That would be accomplished by the purchaser issuing a new note for the entire noncash portion of the purchase price. Is the unstated interest computation based on the wraparound note or on the excess of the wraparound note over the existing

“(cc) is a partnership which immediately prior to the date of the sale or exchange has 35 or fewer partners,

“(II) is a 10-percent owner of a farm or a trade or business,

“(III) pursuant to a plan, disposes of—

“(aa) an interest in a farm or farm property, or

“(bb) his entire interest in a trade or business and all substantially similar trades or businesses, and

“(IV) the ownership interest of whom may be readily established by reason of qualified allocations (of the type described in section 168(j)(9)(B), one class of stock, or the like).”

mortgage (assuming the mortgage was in existence on October 15, 1984, or otherwise qualifies for an exception under the unstated interest rules)? In that connection, if the interest on the wrap-around note falls below the testing rate, is there unstated interest, even if the effective rate of interest on the portion of the note that exceeds the amount of the underlying mortgage satisfies the testing rate? Those questions may very well be answered in regulations issued by the Treasury.

[8] Other Open Issues

[a] *Contingent Purchase Price*

IRC Section 1275(d) grants the Treasury broad regulatory authority to issue regulations to prescribe rules under, or modify the rules set forth in, IRC Sections 1274 and 1275 to carry out the purposes of the subpart of the Code. Areas of concern which are listed in the subsection include varying rates of interest, indefinite maturities and contingent payments.¹⁰⁹

[i] *Contingent Payments, Generally*

The regulations under existing IRC Section 483 deal with contingent payment sales and sales involving contingent interest. They were incorporated into the temporary regulations under IRC Section 453 with respect to contingent payment sales.¹¹⁰ Those rules could be used as a basis for regulations under IRC Section 1274. The rules under the present IRC Section 483 regulations deal with both contingent payments of sales price and contingent interest.

[ii] *Contingent Payment on Sales Price*

If the contract provides for any indefinite payments, current regulations under IRC Section 483 provide that the imputed interest rules should be applied to each such indefinite payment as if it (and any amount of interest attributable to such indefinite payment) were the only payment due under the contract. The effect of the imputed interest rules should be determined at the time the

¹⁰⁹ See N 101, *supra*.

¹¹⁰ See Temp Reg § 15A.453-1(c).

payment is made.¹¹¹ A contingent payment is considered indefinite if the liability for, or the amount or due date of, such payment cannot be determined at the time of sale or exchange. Under this structure, the greater the deferral of the contingent payment, the greater its interest component and the smaller its principal component.

[iii] *Contingent Interest*

If a contract provides for contingent interest, current regulations under IRC Section 483 provide that no part of such contingent interest should be taken into account for purposes of computing imputed interest until it is actually paid.¹¹² Thus, contingent interest is not taken into account in determining whether there is unstated interest under the contract.¹¹³ Interest is considered contingent if the liability for, or the amount or due date of, such interest cannot be determined at the time of the sale or exchange.¹¹⁴

If a portion of the contingent interest is actually paid, such payment is treated as a portion of the sales price if such sale price is wholly or partly contingent, or as a change in the contract terms if the portion of the sale price to which the interest is attributable is definite (and the transaction is one in which inadequate interest has been stated). Such change in the contract terms requires a recomputation of unstated interest.¹¹⁵ These rules could be applied to both the seller's side and the purchaser's side of the transaction.

[b] *Interaction of OID Rules and Installment Sale Rules*

In addition to the complexities and uncertainties introduced into the law, TRA 1984 fails to settle one of the most important

¹¹¹ See Reg § 1.483-1(e)(1) (issued prior to amendment of IRC § 483 by TRA 1984).

¹¹² See Reg § 1.483-1(e)(2) (issued prior to amendment of IRC § 483 by TRA 1984).

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ See Reg § 1.483-1(f)(1) (issued prior to amendment of IRC § 483 by TRA 1984).

and confusing issues regarding the treatment of interest. That issue is whether the parties' designation of payments as interest or principal will be respected, or whether the parties' designation is now irrelevant. Under prior law, it was generally settled that the parties could designate payments as between interest and principal and that designation would be respected by the Service and the courts, provided there was substance to that designation.¹¹⁶ Therefore, points paid for the use of money (rather than for services performed in connection with the loan) were regarded as prepaid interest and treated as such by both borrower and lender.

Under the new law, the imputed principal amount of the debt obligation is computed by discounting, by 120 percent of the applicable federal rate, all of the payments to be made under the debt in a single manner, without regard to whether those payments constitute interest or principal as designated by the par-

¹¹⁶ In general, the courts have been quite liberal in allowing taxpayers to allocate repayment of a loan between interest and principal. For example, in *Huntington-Redondo Co v Commr*, 36 BTA 116 (1937), *acq* 1937-2 CB 14, the court held that the parties to a loan agreement have the right to agree to an allocation of payments between interest and principal and that any such allocation will be determinative for income tax purposes. See also *Sefton v Commr*, 292 F2d 399 (9th Cir 1961). More specifically, in *EP Greenwood v Commr*, 34 BTA 1209 (1936), *acq* 1937-1 CB 11, the court held that the parties can agree to have all payments allocated first to interest, and in *O'Dell v Commr*, 26 TC 592 (1956), *acq* 1963-1 CB 4, the court held that the parties can agree to have all payments allocated first to principal.

The Service has been quite liberal in this regard also. The Service held in *Rev Rul 63-57*, 1963-1 CB 103, for example, that if parties to a loan agree that payments on a note will be charged to principal, and only after principal is repaid to interest, the lender will have no income until receipt of payments designated as interest under the repayment agreement. Further, in *Rev Rul 70-647*, 1970-2 CB 38, the Service held that the parties' agreement to the designation of a payment to principal may be inferred from the circumstances of the loan.

Moreover, it appears that payments can be allocated to interest even if the interest has not yet been earned on the loan. Points paid in advance for the use of money are a prime example of this phenomenon. Several more recent cases, such as *Sandor v Commr*, 62 TC 469 (1974), *aff'd* 536 F2d 874 (9th Cir 1976), and *Burck v Commr*, 533 F2d 768 (2d Cir 1976), have treated points as interest, albeit prepaid interest. In fact, points paid for the use of money are now statutorily recognized as interest as a result of the Tax Reform Act of 1976. IRC § 461(g) recognizes that "points" not paid for services may be treated as interest and, indeed, subsection (g)(2) permits a current deduction for points treated as prepaid interest under certain circumstances if connected with a mortgage on the payer's personal residence.

ties.¹¹⁷ The theory behind that treatment is, first, that money is fungible and, second, that the compensation that the lender receives for the use of the money by the borrower and his forbearance is determined by the excess of what he ultimately receives over the true amount of the outstanding debt obligation. Moreover, the debtor's interest deduction is determined under the OID rules based upon interest that is deemed to accrue economically for the relevant period, and not on the basis of the payments of interest actually made.

Nevertheless, a literal reading of the rules applicable to the seller of property for deferred payments indicates that the designation of the purchaser's payments between interest and principal would still have tax consequences to the seller. For example, a seller sells property that qualifies as a capital asset and is worth \$200,000, with a basis of zero, for an installment note providing the following terms: interest of 10 percent compounded annually (assuming that that interest rate satisfies the testing rate under IRC Section 1274 even though compounding is only annually), with installments payable \$100,000 at the end of year one and \$100,000 plus \$32,000 of interest payable at the end of year two. The question arises as to how much capital gain is recognized by the seller in each of years one and two, and it appears that there are three possible answers:

- (1) \$100,000 in year one, and \$100,000 in year two;
- (2) \$90,900 in year one, and \$109,000 in year two; or
- (3) \$80,000 in year one, and \$120,000 in year two.

Each of the possible answers can be justified, but ultimately only one can describe the actual tax consequences.

The argument in support of the first possible result, \$100,000 of capital gain in year one and \$100,000 of capital gain in year two, proceeds as follows. IRC Section 1274 leaves the labels on payments unaffected as long as there is no unstated interest. The section merely sets forth how interest will be deemed to accrue. Here, under the computation of IRC Section 1272, \$20,000 of interest accrues in year one, even though none of that amount will

¹¹⁷ See text accompanying N 52, *supra*.

be paid until the end of year two. In year two, \$12,000 of interest accrues¹¹⁸ (10 percent of \$120,000). The amounts designated as principal payments result in capital gain to the seller in their full amount (the property had a zero basis), because those amounts are determined completely separately from the computation of accrued interest. This treatment clearly is detrimental to the seller, but can be avoided by designating the payments differently.

The second possibility is to charge the seller with \$90,900 of capital gain in year one and \$109,000 of capital gain in year two. That treatment can be justified in the following way. A two-payment installment note should be treated as two separate notes because the parties could have provided for two separate notes. The \$100,000 "note" has an unstated interest element of \$9,100, leaving a principal amount of \$90,900 paid in year one. The second \$132,000 note has a principal portion (present value discounted back for two years) of \$109,100, the remainder of the second note being interest.

This result, however, seems unlikely because:

- (1) The Section 1274 unstated interest rules are not applicable to the transaction and should not be made applicable artificially; and
- (2) If they were made applicable artificially, it is likely that one should discount not at 10 percent (the test rate) but rather at 10.9 percent (the unstated interest rate).¹¹⁹

The third possible tax consequence to the seller is \$80,000 of capital gain in year one and \$120,000 of capital gain in year two. That treatment may be supported by the following arguments. The amount of accrued interest in year one is \$20,000 (10 percent \times \$200,000 (issue price)). There is a general common law rule that payments should be allocated first to earned interest and then to principal, unless the parties provide otherwise.¹²⁰ IRC Section

¹¹⁸ That amount is computed by applying the 10-percent rate to the outstanding principal balance (\$100,000) plus accrued interest (\$20,000). Thus, 10 percent of \$120,000 equals \$12,000.

¹¹⁹ 120%

110% \times 10% = 10.9%

¹²⁰ See, eg, *Est of Bowen v Commr*, 2 TC 1 (1943), *acq* 1943 CB 3; Rev Rul 70-647, 1970-2 CB 38.

1274, however, arguably overrides that rule because the thrust of that section is to provide a universal rule to determine how much of each payment economically constitutes interest and treat the parties accordingly. The parties should not be able to vary that treatment without changing the economics of the transaction. This method conforms to the usual economics and agreement of the parties pursuant to which each payment is comprised of all interest earned during the period plus an amortization of a portion of the principal.

The difficulty with that argument is its disregard, without express statutory support, of well settled case law which respects the parties' labeling of interest and principal.¹²¹ Moreover, to overrule the longstanding, albeit questionable, rule that respects labeling of interest and principal would overrule all of the provisions dealing with points. Yet points are expressly treated as prepaid interest and in limited circumstances as deductible when paid.¹²²

A second argument supporting this treatment proceeds from its inconsistency with the treatment of unstated interest. If the stated interest had not satisfied the test rate, then the first year's payment would have contained a large interest element.¹²³ Missing the test rate by a small amount should not drastically change the tax results. However, these consequences are all within the control of the parties as they could have satisfied the test rate and obtained their designated tax consequences, even though generally less desirable.

The selection of this last possible treatment on the theory that the parties' labeling of payments should be disregarded, moreover, logically leads to another important, and possibly unforeseen, change in the tax law. It appears that if that tax result were adopted as the rule, IRC Section 1274 effectively would cause points and other prepaid interest to be amortizable on an economic rather than a straight-line basis. That result may be a sensible one, but not one that seems to have been expressly contemplated by the legislators.

¹²¹ See Ns 115 and 120, *supra*.

¹²² See IRC § 461(g)(2) relating to points paid with respect to the taxpayer's principal residence. See N 13, *supra*.

¹²³ The amount would be approximately \$23,000, applying 120 percent of the applicable federal rate as the discount factor.

Thus, even after the sizeable amount of legislation required for these new rules, there remains substantial uncertainty with regard to the treatment of payments designated as interest by the parties. As the illustration points out, that uncertainty extends to the treatment by both borrower and lender of prepaid interest and points paid for the use of money.

§ 23.05 CRITIQUE AND OUTLOOK FOR THE FUTURE

It is widely believed that the last chapter has not yet been written in the saga of the unstated interest and OID rules. Many tax practitioners believe that additional changes of the rules are necessary, and perhaps a rethinking of the concepts would be in order. The statute as it exists now is extremely complicated from a conceptual point of view. Moreover, it is technically complicated because it builds exception upon exception and could affect even the most commonplace transactions.

Conceptually, the statute is designed to force transactions to take the form of their economic substance. That is accomplished by compelling taxpayers to charge market interest rates on seller-financed transactions. Nevertheless, the legislation has major failings arising primarily from its attempt to achieve economic precision with the accompanying technical complexities. If one thing can be said for congressional action under TRA 1984, it is that Congress adhered to the "truth in labelling" precept by not having labeled its legislation "tax simplification."

[1] Adjustable Testing Rate

The statute's goal of forcing the amount charged for the use or forbearance of money, namely interest, to be treated as interest regardless of whether it is called principal is laudable. In that respect, the statute carries out an objective that has been in the Code since the enactment of IRC Section 483 in 1964.¹²⁴ In addition, the statute's use of a testing rate computed on a compound basis rather than a simple basis is essential for the imputed interest provisions to operate correctly, and to prevent them from being subject to substantial abuse.

¹²⁴ IRC § 483 was originally enacted under the Revenue Act of 1964, Pub L No 88-272, 88th Cong, 2d Sess (Feb 26, 1964).

However, the statute ambitiously attempts to attain precision in determining the interest element by the use of a self-adjusting testing rate. That rate follows market interest rates because it is based on the interest rate borne by comparable federal obligations. It is adjusted every six months, based upon the federal rate determined between three and nine months earlier. The complexity is magnified because the statute provides three different rates depending upon the term of the obligation being tested instead of being set at a fixed amount, as it was under former IRC Section 483. That extra precision in the statute adds a substantial amount of complexity to the law and creates an undue burden for taxpayers seeking to comply with the law.

The difficulties that the mechanism creates for complex business transactions should not be underemphasized. It is conceivable that in a heavily negotiated transaction, the purchaser and seller of property will not know at the planning stages what interest rate to set for the transaction, because the negotiations could last through the end of the applicable period of the rates. Accordingly, the mere passage of time could force the purchaser and seller, both intending in good faith to comply with the law, to change the economic deal they have made.

It is even questionable whether precision will be achieved through this structure. The theory of the automatic adjustment provisions is that the interest rate on federal obligations of the previous year will be a good indication of market rates at the time the transaction is consummated. Wide shifts in market interest rates would call that assumption into doubt.

Moreover, the applicable federal rate is based upon a federal obligation that pays interest periodically but principal at the end of the term of the obligation. In many privately negotiated transactions, the seller financing will take the form of an installment note, rather than a balloon note payable at the end of its term. As a result, it is questionable whether the testing rate, 110 percent of the applicable federal rate for a similar term obligation, will be an appropriate approximation of the market rate for the purchaser's installment note. For example, if the purchaser gives the seller a ten-year installment note, it is indeed possible that the interest rate on that note would exceed a market interest rate for that note if

the note were forced to carry an interest rate equal to 110 percent of the long-term federal rate.

In enacting the Revision, Congress sought to make the new imputed interest rules less harsh to most taxpayers, at least temporarily, yet retain their teeth with respect to larger transactions. In that connection, the imputed interest rules applicable to the first six months of 1985 use a blended testing rate based upon 9 percent for the first \$2 million of seller financing and 110 percent of the applicable federal rate for the excess over \$2 million.¹²⁵ That provision for transactions exceeding \$2 million adds additional complexity by forcing on the purchaser and seller an additional computation that must be made in order to comply with the rules.

Much of the objective of the new legislation could have been accomplished without the undue complexity by simply changing the testing rate under IRC Section 483 from 9-percent simple interest to 9-percent interest compounded semiannually. In lieu of that more moderate change, Congress apparently used as its model the floating rate concept of interest applicable to interest on tax deficiencies.¹²⁶ That provision was designed to reflect the value to the taxpayer of having delayed its payment of tax to the government. Any complexity involves only after the fact computational difficulty. In contrast, the adjustable rate concept applied to govern privately negotiated transactions fails to take into account the effect on nontax motivated business transactions, the economics of which are highly dependent upon the interest rate required to be stated. The adjusting rate provisions reflect Congress's insensitivity to the legitimate needs of business people.

[2] Economic Accrual

The second major aspect of the new legislation is to force taxpayers to account for interest as it accrues economically rather than as it is stated by the parties. Prior to TRA 1984, the Service had sought to inject this requirement into the tax system by issuing Revenue Ruling 83-84.¹²⁷ Presumably because that attempt

¹²⁵ See text accompanying Ns 93-97, *supra*.

¹²⁶ See IRC §§ 6601 and 6621.

¹²⁷ 1983-1 CB 97.

might have provoked judicial challenge, Congress instituted that reform by means of legislation.

The portion of the legislation requiring economic accrual of interest appears to be well conceived, sensible and not unduly burdensome on taxpayers. In many transactions, interest is paid currently so that in no event is interest earned on interest anyway. In those cases, therefore, the requirement of accounting for interest as it economically accrues has no effect on either purchaser or seller.

In transactions in which interest accrues but remains unpaid, the taxpayers themselves surely have taken into account for financial and economic purposes the fact that the seller must await the payment of interest. Further, they would have certainly taken into account that any accrued interest is worth to the seller the exact amount that accrues only if that interest continues to earn interest at the market rate. Accordingly, if simple interest were stated by the parties, one would expect the seller and purchaser to adjust other aspects of the transaction to compensate the seller for the detriment. In that sense, the requirement to account for interest as it economically accrues merely permits the tax consequences to follow the economic consequences that both purchaser and seller expect and indeed have negotiated.

[3] Seller Inclusion of Interest Without Receipt

The third aspect of the new legislation is generally to place the seller and the purchaser on the accrual method of accounting with regard to interest in transactions governed by IRC Section 1274. The seller's inclusion in income of interest that is earned but not received, even if he otherwise employs the cash method of accounting, causes his treatment to correspond to the purchaser's income deduction with regard to that accrued interest.

Although an argument can be made for the equity of this result, it causes an extra layer of complexity to a cash-method seller who generally accounts for payments under the cash method when he receives them. In addition, it could cause a hardship to the seller because he would be required to pay tax on income that he has not yet received. Those two consequences, however, could be accepted as a matter of tax policy if to do so would be consistent with the overall tax policy of the Code.

It is clear, however, that the inclusion in a cash-method seller's income of accrued but unpaid interest is inconsistent with other provisions of the Code. Most importantly, it is inconsistent with the cash-method seller's treatment of sale proceeds. Under the installment method, the seller of property sold at a gain does not report the sale proceeds as an amount realized until he has received those proceeds.¹²⁸ Accordingly, the seller does not report gain on the sale until he has received at least a portion of the sale proceeds, and then the gain reported is only proportional to the entire gain to be realized on the sale.¹²⁹ If the seller does not receive any sales proceeds until the entire note becomes due, he does not report any gain (except for recapture, if any)¹³⁰ until the payment is actually received. The justification for delaying reporting of income under the installment method is to permit a seller to avoid the hardship of paying tax on gains represented by amounts that he has not yet received.¹³¹ That same justification supports deferral of interest income to the seller arising out of the sale transaction, and indicates the inconsistency in result legislated under TRA 1984.

A lack of consistency between the cash-method seller's treatment of interest, reportable when the cash is actually received, and the accrual-method purchaser's treatment of interest, deductible when it accrues, although seemingly abusive, should not be disturbing. That treatment is analogous to the inconsistent treatment accorded a seller and purchaser with regard to the deferred payment of the purchase price. Even though an installment method seller may defer recognition of gain until receipt of the sales proceeds, the purchaser, whether using the cash method or the ac-

¹²⁸ IRC § 453. TRA 1984, however, creates an exception to this rule with respect to recapture amounts under IRC §§ 1245 and 1250. IRC § 453(i).

¹²⁹ IRC § 453(c) and Temp Reg § 15A.453-1(b), which, in general, provide that the seller reports as gain that portion of the installment payment received in that year which the gross profit (selling price minus adjusted basis) realized or to be realized bears to the total contract price (selling price minus indebtedness) assumed by the purchaser or to which he takes the property subject. See generally Goldberg, "Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980," 34 *Tax Law* 605 (1981).

¹³⁰ See N 128, *supra*.

¹³¹ See generally Goldberg, "Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980," 34 *Tax Law* 605 (1981).

crua method, obtains a basis in the property that includes the amount of his purchase money debt.¹³² The purchaser is entitled to cost recovery deductions on the full purchase price, including the debt, even though the seller has not yet reported the income. One may suggest that the purchaser in that event is treated more favorably than he should be, but that treatment of the purchaser has a long history in the tax law and is not likely to be changed.

Moreover, lack of consistency between the treatment of the purchaser and the seller with regard to the sales proceeds was approved by Congress in 1980. In that year, Congress substantially revised the installment sales provision by enacting the Installment Sales Revision Act of 1980,¹³³ making it easier for sellers to qualify for that favorable treatment. In doing so, Congress did not seek to alter the inherently inconsistent treatment of seller and purchaser. If that inconsistency is acceptable with regard to treatment of the sales price and the purchaser's basis in the property, then it should be equally acceptable with regard to the treatment of interest.

Proponents of the new legislation, on the other hand, could argue that the treatment of interest is generally determinable under the OID rules, which were enacted in the Tax Reform Act of 1969.¹³⁴ Under those rules, a noteholder is required to report OID as income even if that noteholder uses the cash method of accounting. The exception generally accorded seller financed debt from those rules represented an anomaly from the general treatment of loans involving disguised interest stated as principal.

That argument, however, is inapposite. The transactions that were subject to the original issue discount rules prior to TRA 1984 were generally loan transactions. The OID rules, although complicated, could deal with those transactions because the only income involved was interest income, whether stated or in the form of OID. The policy objectives sought to be accomplished by subjecting those transactions to ratable interest inclusion to the lender were designed to curb the abuse inherent in permitting deferral of OID income.¹³⁵

¹³² *Crane v Commr*, 331 US 1 (1947).

¹³³ Pub L No 96-471, 96th Cong, 2d Sess (Oct 19, 1980).

¹³⁴ Pub L No 91-172, 91st Cong, 1st Sess (Dec 30, 1969).

¹³⁵ See *US v Midland-Ross Corp*, 381 US 54 (1965).

Interest on seller-financed debt, however, should be distinguishable from interest on pure loan transactions. Application of the OID rules to sales transactions includes the added complexities of requiring sophisticated computation of the OID portion, a computation relatively easy in straight loan transaction situations in which the principal amount of the loan is a given.

The congressional intent, exemplified in the installment sales rules, to allow deferral of gain on the sale of property until sales proceeds are received, should be extended to all income resulting to the seller from the sale transaction, including interest income.¹³⁶ It should be immaterial whether the seller's income would be taxable as capital gain, as would generally be the case with sale proceeds, or ordinary income, as would be the case with interest income.

In cases in which the imputed interest provisions apply causing a portion of the principal to be treated as interest, IRC Section 483, both as amended by TRA 1984 and in its previous form, in substance, treats both purchaser and seller regarding the unstated interest portion, as if they were using the cash method of accounting. Thus, the unstated interest portion is accounted for by both purchaser and seller at the time the interest payment is made. That treatment does not result in the inconsistency at which the OID rules are directed and therefore may be viewed as a solution, albeit a different solution, to the problem to which the OID rules were directed. Moreover, it is a simpler solution and a more favorable one to the cash-method seller, although it is, of course, less favorable to the accrual-method purchaser. It applies, however, only to the unstated portion of the interest and not to accrued but unpaid interest.

In summary, the major abuses at which the new legislation was directed could have been dealt with by simply: (1) amending the regulations under IRC Section 483 to require a testing rate based upon compound interest rather than simple interest, and (2) requiring interest, whether stated or imputed under IRC Section 483, to be accounted for as it economically accrues.

¹³⁶ In that connection, the new recapture rule of IRC § 453(i) is also subject to this criticism.

Admittedly, IRC Section 483 is not itself a simple tax provision. There are substantial complexities already contained in IRC Section 483 and the regulations thereunder. Nevertheless, with the modifications suggested in this article, the primary deficiencies of that section could have been corrected and tax practitioners and business people would not have been required to deal with an entirely new regime of complexity and uncertainty.

§ 23.06 CONCLUSION

This article explained the theoretical underpinnings and practical intent of the changes in the treatment of interest wrought by Congress in TRA 1984 and the Revision. The article then undertook to catalogue the myriad of exceptions, special rules and special effective dates resulting largely from political compromise that has made this legislation a patchwork of complexity and confusion. Those explanations, in and of themselves, may have been sufficient to convince the reader of the deficiencies of the legislation.

Additionally, the article suggested a different approach to combat abuses under pre-TRA 1984 law. That approach would involve few but important modifications of former IRC Section 483 and would be more consistent with the existing structure of the tax law.

It is likely that Congress will have the opportunity to reexamine and could revise substantially the rules in this area. One would hope that ease of compliance would be one of Congress's objectives the next time around.